

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
FRANK LUNA LOPEZ)

Appearances:

For Appellant: Frank Luna Lopez,
in pro. per.

For Respondent: Mark **McEvilly**
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Frank Luna Lopez for redetermination of jeopardy assessments of personal income tax in the amounts of **\$53,154.00** for 1973 and **\$9,495.00** for the period January 1, 1974, through March 8, 1974.

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The issues for determination are the following: (i) did Frank Luna Lopez receive unreported income from the illegal sales of narcotics during the appeal period; and (ii) if so, did respondent properly reconstruct the amount of that income, The relevant facts are set out below.

From as early as 1969, the Stockton Police Department (SPD) had been advised that appellant **was** involved with the sale of drugs from the Estrellita Bar which he owned and operated. Such information was provided in 1969 by the Federal Bureau of Investigation and in 1969 and 1970 by the California State Department of Justice, Bureau of Narcotic Enforcement. Furthermore, from 1972 and on through the appeal period, fourteen different confidential and reliable informants also reported instances of appellant's involvement with the sale of heroin. Various and detailed reports of such informants indicated that appellant sold heroin out of his bar and that additional sales were made through a network of ten to fifteen subdealers.

The reports also included instances of known narcotics violators frequenting appellant's bar and being in his company; instances of heroin purchases from appellant by informants using money supplied by SPD; instances of narcotics purchases from appellant by arrested narcotics traffickers and users; and instances of appellant having traveled to Mexico to purchase heroin and other drugs, or to arrange for their shipment. The reported prices at which appellant and his subdealers sold heroin ranged from \$25.00 to \$50.00 per "spoon" (one balloon).

The SPD was also informed that appellant's method of distribution to his subdealers was to secrete heroin in various locations and then tell the distributors where the heroin was hidden so that they, in turn, could further distribute it.

The flow of information regarding respondent's sales activities continued unabated into 1974. In the first week of March 1974, SPD received information that on March 8, 1974, appellant would be making a heroin distribution run. According to the informant, appellant was going to hide a packet of heroin between the toilet tank and the wall of a restroom in a specifically designated Texaco service station for later pickup by one of his dealers. The informant also gave the location and time of a subsequent meeting for a pre-arranged sale of heroin that appellant was to make to some buyers.

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On the morning of March 8, 1974, SPD placed appellant's residence under surveillance. At 10:00 a.m., appellant left his house, made one stop, then drove directly to the Texaco station described by the informant. He entered the restroom and left a white packet containing ten heroin-filled balloons wedged between the toilet tank and the wall. After appellant left the service station, he proceeded to the exact location where the pre-arranged heroin sale was to take place. Prior to his arrival there, SPD had positioned their personnel at that location. While waiting for appellant to arrive, the police received radio information that appellant had left the heroin packet at the service station. On the basis of this information, the police questioned three men who arrived at the meeting place location. Two of the men admitted that they were there to buy heroin from appellant. Shortly thereafter, appellant arrived and called out to one of these men. At that point SPD arrested appellant and two other occupants of his car. Each arrestee was armed with a loaded firearm at the time of the arrest and a package of ten balloons of heroin was also recovered as part of that arrest.

Searches of appellant's bar and home and of his son's home, his son having been implicated as one of his subdealers, yielded numerous toy balloons of the type used to package heroin, a substantial quantity of lactose (a substance used to decrease the purity of heroin down to levels at which it is commonly sold) two metal funnels, \$2,974.75 in cash, various firearms, and a total of 117.1 grams of heroin.

An additional 330 grams of 37 percent pure heroin was also discovered as a result of a tip. Appellant had made a phone call, in Spanish, from the jail facility. Apparently, he had instructed a friend to go to a certain house and have the resident thereof look under the tree in the backyard. When the police went to the described location, they found evidence of recent digging under the backyard tree, and upon digging further, found a package containing the 330 grams of heroin.

On March 11, 1974, respondent's representatives learned of appellant's arrest, and after contacting SPD, was informed of the extensive nature of sales activities attributed to appellant.

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Based on this information, respondent determined that appellant's narcotics sales resulted in unreported taxable California income for 1973 and for the period January 1, 1974, through March 8, 1974. It was further determined that the collection of tax would be jeopardized by delay. Jeopardy assessments were therefore issued on March 11, 1974, for each of these taxable periods reflecting a net tax liability of \$53,154.00 for 1973 and \$9,495.00 for the 1974 period. An "Order to Withhold" in the total amount of \$62,649.00 was served upon SPD and a total of \$3,837.30 was received.

On May 6, 1974, appellant filed a petition for reassessment. In June 1976 respondent received a statement of financial condition and financial questionnaire completed by appellant. On this questionnaire appellant claimed to have realized only \$383.00 in gross income for the period January 1, 1974, through March 8, 1974, and only \$3,592.00 in gross income for 1973. Respondent thereafter requested information from appellant regarding income earned from narcotics sales. In March of 1977 appellant notified respondent that no further information was being submitted. Subsequently, after due consideration of appellant's contentions, respondent affirmed the two disputed jeopardy assessments and this appeal followed.

The initial question presented by this appeal is whether appellant received any income from illegal sales during the period in issue. From information contained in the related arrest report, search warrants, affidavits for such warrants and a probation report, we know that as early as 1969, appellant's activities in the drug dealing area were identified by government authorities. These documents also describe numerous instances of drug selling activity reported to SPD by fourteen different informants throughout the appeal period. During this same period, several other drug users and traffickers also admitted having purchased heroin from appellant. These factors coupled with the circumstances of appellant's arrest and the heroin and drug paraphernalia discovered as a result of related searches and investigation, establish at least a prima facie case that appellant received unreported income from the illegal sale of narcotics during the appeal period.

The second issue is whether respondent properly reconstructed the amount of appellant's income from

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drug sales. Under the California Personal Income Tax Law, a taxpayer is required to specifically state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) As in the federal tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided by law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) Gain from the illegal sale of narcotics constitutes gross income. (Farina v. McMahon, 2 Am.Fed. Tax R.2d 5918 (1958).)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4); Treas. Reg. § 1.446-1(a)(4).) In the absence of such records, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In the instant appeal, respondent used the projection method to reconstruct appellant's income from the illegal sale of heroin. Because of the difficulty in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this court. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.)

It has also been recognized, however, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure

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the use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr McFarland Lyons, supra.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax is due and owing. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be revised or modified. (Appeal of Burr McFarland Lyons supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

Respondent used information obtained by the Stockton Police Department. The information indicated that appellant had been selling heroin at least as far back as 1969 and continuously throughout the appeal period. The information also shows that appellant utilized ten to fifteen subdealers, who collectively were selling about three ounces of heroin per day. However, no information indicates that this was other than the type of heroin sold on the street, i.e., it was not three ounces of heroin that had yet to be thinned with lactose or some other similar substance. Assuming, therefore, that the three ounces of heroin refers to street-quality heroin, this quantity, when converted into the "spoon" (balloon) units used by respondent in reaching its determinations, is, per our calculations, equivalent to 54 "spoons." Respondent, on the other hand, based its estimate of the subdealers' collective sales on a daily average of 100 "spoons." We believe the 54 "spoon" average is the more accurate figure and should be used as the basis for estimating the gross income attributable to heroin sales made by the subdealers. In effect, this calls for a 46 percent reduction in respondent's determination of the subdealers' gross receipts.

The gross income that respondent attributes directly to appellant from his personal sales of narcotics also requires adjustment. Respondent determined that a certain amount of weekly wholesale narcotics sales were made by appellant himself. This figure was

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projected over all the weeks in the appeal period. However, this projection failed to take **into** account the weeks that appellant was said to have been on heroin buying trips in Mexico and elsewhere. The record is capable of being construed as indicating that appellant was on such trips for a total of six weeks in 1973 and a total of four weeks in the 1974 period under appeal. Consequently, gross income attributable to appellant's personal sales should be reduced accordingly.

The last item to be considered is the propriety of a cost of goods allowance. Respondent allowed appellant a liberal cost of goods exclusion. Based on a presumption of correctness and the information before **us**, the exclusion percentage will be allowed to stand.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Frank Luna Lopez for redetermination of jeopardy assessments of personal income tax in the amounts of \$53,154.00 for 1973 and \$9,495.00 for the period January 1, 1974, through March 8, 1974, be and the same is hereby modified to reflect a reduction of 46 percent in the gross income respondent attributes to the subdealers' sales of heroin, and a reduction of six weeks worth of gross receipts for 1973, and four weeks worth of gross receipts for the 1974 period in regard to the gross income attributable to the heroin sales made by appellant himself. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 29th day of September, 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman
George R. Reilly, Member
Richard Nevins, Member
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